Internal Revenue Service

memorandum

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Br4:GBFleming

date: MAY 12 1989

to: District Counsel, Houston SW:HOU
Attention: John F. Eiman

from: Assistant Chief Counsel (Tax Litigation) CC:TL

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subject: [redacted]

This responds to your memorandum of March 1, 1989, requesting Tax Litigation Advice concerning the issue in the above-referenced refund litigation. Because this is an issue of first impression and affects proposed regulations issued pursuant to I.R.C. § [redacted]A, we are coordinating this matter with the Assistant Chief Counsel (Passthroughs & Special Industries) and will supplement this response to the extent necessary upon receiving the views of P&SI.

ISSUE

Whether I.R.C. § [redacted]A(d)(3) limits the attribution of stock to one tier beyond the tier of actual ownership for purposes of determining independent producer status.

FACTS

The facts in this case are not in dispute and are briefly as follows. The plaintiff, [redacted] ("[redacted]") engages in various petroleum activities that include the [redacted]. Its refinery runs did not exceed 50,000 [redacted] on any day during the taxable periods at issue -- i.e., [redacted]. During the relevant taxable periods, more than five percent of [redacted]'s common stock was owned, however, by [redacted], a wholly owned subsidiary of [redacted] ("[redacted]"). [redacted], in turn, owned [redacted] percent of the stock of [redacted] and also owned [redacted] percent of [redacted], which operated a refinery. The combined refinery runs of [redacted] and [redacted] exceeded 50,000 [redacted] per day during each of the taxable periods at issue.

On its WPT returns for the taxable periods at issue, [redacted] calculated its liability at the lower rates provided for independent producers. The notice of deficiency issued on

[redacted], determined that [redacted] was not an independent producer because its refinery runs, when combined with those of [redacted], exceeded 50,000 [redacted] during the relevant taxable periods. [redacted] paid the deficiencies and assessed interest, filed timely claims for refund, and then commenced the instant action for refund in the United States Claims Court.

DISCUSSION

The principal question in this litigation is whether [redacted] properly claimed independent producer status in filing its WPT returns for the last [redacted] taxable periods of [redacted]. During those taxable periods, [redacted] owned more than five percent of the common stock of [redacted]. As outlined in your memorandum, this question ultimately turns on whether [redacted] is considered a "related person" with respect to [redacted] within the meaning of I.R.C. § [redacted]A(d)(3).

For WPT purposes, I.R.C. § 4992(b)(1) defines "independent producer" to mean, with respect to any calendar quarter in any calendar year, any person other than a person to whom section [redacted]A(c) does not apply for such calendar year by reason of paragraph (2) (certain retailers) or paragraph (4) (certain refiners) of section [redacted]A(d). Section [redacted]A(d)(4) provides that section [redacted]A(c) does not apply if a taxpayer or a related person engages in the refining of [redacted] and on any day during the taxable period the refinery runs of the taxpayer and such person exceed 50,000 [redacted].

[redacted]'s own refinery runs were less than 50,000 [redacted] on every day during the taxable periods at issue. Therefore, [redacted] would not be considered a refiner within the meaning of section [redacted]A(d)(4) unless the addition of any refinery runs of a related person resulted in combined refinery runs greater than 50,000 [redacted]. Under the given facts, the sum of [redacted]'s and [redacted]'s refinery runs exceeded 50,000 [redacted] during the taxable periods at issue. Thus, if [redacted] is treated as a related person within the meaning of section [redacted]A(d)(3), [redacted] will be considered a refiner for purposes of section [redacted]A(d)(4).

As relevant in this case, section [redacted]A(d)(3) provides that a person is a related person with respect to the taxpayer if a third person has a significant ownership interest in both the taxpayer and such person. In the case of a corporation, a significant interest means 5 percent or more in value of the outstanding stock of such corporation. I.R.C. § [redacted]A(d)(3)(A). Section [redacted]A(d)(3) also sets forth the following attribution rule:

[redacted]

The interpretation of this attribution rule is the sole issue in this litigation. If [redacted], a third person, is treated as owning a significant interest in [redacted] and [redacted], the refinery runs of [redacted] and [redacted] must be aggregated. Based on the aggregated refinery runs, section [redacted]A(d)(4) would apply to exclude [redacted] from independent producer status for purposes of percentage depletion and WPT.

[redacted] contends that [redacted] does not own a significant interest in [redacted] under the attribution rule of section [redacted]A(d)(3). The basis for [redacted]'s position is set forth in a memorandum ("Memorandum") that was included as Exhibit E to the complaint. Briefly, [redacted] contends that the attribution rule of section [redacted]A(d)(3) operates to attribute ownership of [redacted]'s stock to only one tier beyond the tier of actual ownership. Under [redacted]'s interpretation, the [redacted] stock owned by [redacted], concededly more than five percent, is attributed to [redacted] but is not attributed from [redacted] to its parent, [redacted].

In support of its interpretation, [redacted] cites language expressly allowing further attribution in other attribution provisions of the Code. Specifically, [redacted] refers to the attribution rule stated in section 267(c), which provides as follows:

> (1) Stock owned, directly or indirectly, by or for a corporation, . . . shall be considered as being owned proportionately by or for its shareholders.
>
> . . .
>
> (5) Stock constructively owned by a person by reason of the application of paragraph (1) shall, for the purpose of applying paragraph (1), (2), or (3), be treated as actually owned by such person . . . .

Memorandum at 10. [redacted] cites similar language in sections 318(a), 544(a), 554(a), 897(c)(5)(A), 1563(e) and (f).

Comparing the attribution rule of section [redacted]A(d)(3) with those set forth in the other cited sections of the Code,

[redacted] finds two significant differences. First, unlike the other attribution provisions -- which refer to "stock owned, directly or indirectly, by or for a corporation" -- section [redacted]A(d)(3) refers to "an interest owned by or for a corporation" as being considered owned proportionately by its shareholders. [redacted] argues that the absence of any reference to indirect ownership in section [redacted]A(d)(3) means that only directly owned stock of a corporation is attributed to its shareholders under section [redacted](d)(3). Thus, [redacted] concludes that attribution is can be applied only to the next tier above the tier of actual ownership.

[redacted] also argues that, unlike the other cited provisions, section [redacted]A(d)(3) contains no reattribution rule specifically clarifying that stock interests which a shareholder constructively owns as a result of the application of such attribution provisions are to be treated as actually owned by the shareholder for purposes of further applying the attribution provisions. [redacted] contends that the absence of such a reattribution rule supports the view that attribution of stock is to be applied only once.

Your memorandum, however, suggests alternative theories to support the Government's position that [redacted] should be considered a related person with respect to [redacted]. First, the legislative history indicates that Congress was aware that prior law did not "specify that a significant ownership interest is held when a person indirectly holds a significant ownership interest in another person," and thus the legislative report states that the provision was intended "to prevent taxpayers from avoiding the retailer and refiner exclusions by the use of intermediate entities." S. Rep. No. 938, 94th Cong., 2d Sess. 427 (1976), reprinted in 1976-3 (vol. 3) C.B. 49, 465. In contrast, [redacted] interpretation would frustrate that congressional intent by allowing avoidance through creation of an intermediate corporation between the taxpayer and the person that would otherwise be a related person.

You also point to Example 3 in Prop. Treas. Reg. § 1.[redacted]A-4(b)(2), which implies that multiple reattribution of interests is permitted if the reattributed interest is at least 5 percent.

We agree with your view that [redacted]'s interpretation of the attribution rule is not consistent with the legislative intent of preventing the use of intermediate entities in order to avoid the refiner exclusion of section [redacted]A(d)(4). In addition to the previously cited statements from the legislative history, we believe that there are other

arguments to support the government's position in this litigation.

First, it may be possible to argue that [redacted] can be ignored because it has no valid business purpose and was organized solely for the purpose of avoiding the refiner exclusion provision of section [redacted]A(d)(4). See, e.g., West Coast Marketing v. Commissioner, 46 T.C. 32 (1966). We do not know enough facts concerning the organization and purpose of [redacted] to know whether this argument would be appropriate in this case. If the necessary information is not available in the record, it would be necessary to obtain through discovery the facts needed to determine whether this argument is applicable.

Second, we note that [redacted]'s memorandum fails to note yet another difference between the language in section [redacted](d)(3) and the other attribution provisions. Specifically, the rule of section [redacted](d)(3) provides that "an interest owned by or for a corporation . . . shall be considered as owned directly both by itself and proportionately by its shareholders . . . ." (Emphasis added.) Under this rule, a corporation's shareholders are considered to own directly an interest owned by the corporation. Although the other attribution provisions refer to interests owned "directly or indirectly" by a corporation, they do not refer to direct ownership by the corporation's shareholders.

Arguably, the provision for the shareholders' direct ownership under section [redacted]A(d)(3) can be interpreted to have the same effect as the reference to a corporation's indirect ownership in the other attribution statutes. 1/ In this case, [redacted]'s interest in [redacted] is considered to be owned directly by its sole shareholder, [redacted]. There is no limitation in section [redacted]A(d)(3) on further attribution of this "directly" owned interest from [redacted] to its sole shareholder, [redacted].

Notwithstanding the foregoing discussion and our predilection to advance these views in litigation, we are concerned that [redacted] presents an effective argument that Congress has repeatedly utilized fairly standard language in numerous other attribution provisions to state expressly that reattribution of constructively owned interests is permitted.

1/ In this regard, we note that [redacted]'s memorandum concedes that [redacted] indirectly owns [redacted]'s stock in [redacted] and that there would be no dispute in this case if section [redacted]A(d)(3) contained the reference to indirect ownership. Memorandum at 17-18.

The choice of a different formulation for the attribution rule of section [redacted]A(d)(3) is arguably an indication that Congress did not intend for such reattribution in determining under section [redacted]A(d) whether a taxpayer should be denied independent producer status.

Moreover, there are serious litigating hazards in proceeding with this case in the Claims Court. In addition to the superficial appeal of [redacted]'s argument, the court may view the issue as noncontinuing since WPT has been repealed prospectively. An adverse decision would have a continuing and potentially greater revenue effect on taxpayers' status as independent producers for purposes of percentage depletion. Thus, it may be better strategy to avoid any litigation of this issue until the regulations under section [redacted]A become final.

For the foregoing reasons, we would not be adverse to settlement of this case and, if necessary, full concession of the issue, based on the litigating hazards discussed above.

Please contact the undersigned at 566-3308 or Gerald Fleming at 566-3345 if you have any questions.

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